

# Economic Policy Review



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© IME [www.ime.bg/en](http://www.ime.bg/en)**In the issue:****State Expenditures in 1998-2006****The State Budget by March 2007****A Perspective over the EU Funds****The Legislature in Bulgaria: What happens There?****A Supreme Absurdity**

Institute for Market Economics is a winner of a 2006 Templeton Freedom Award

**State Expenditures in 1998-2006**

Svetla Kostadinova, Dimitar Chobanov

This week the expenditures by functions of the budget for the period 1998-2006 have been published. It is interesting to look at them because they clearly show on what exactly the money from taxes is spent.

The reduction of total expenditures in relation to the GDP creates a significant impression, as in 2006 they reach their lowest rate for the entire period (37.2%). Keeping the incomes on relatively fixed levels leads to an increase in the budget surplus. Instead the released resources could be used for reducing the tax burden.

The expenditures for social security, social assistance, and welfare represent the highest share, as a percentage, of GDP. This is normal as we take into consideration the lack of resources in the insurance funds, the rate of unemployment, as well as the occasionally

generous social payments. Despite that, a decrease in these expenditures is observed for the last 3 years, which is a good trend if preserved. However, examining the whole period from 1998 to 2006 we notice a slight increase in these expenditures.

On the second place, as a share of the budget, are the expenditures for defense and security, as this trend is very astonishing for a small country like Bulgaria. In this area in the last years a smooth decrease is also observed, but the decrease is very insignificant compared to what is possible in reality. Here are included the expenditures for the police and judicial system, which seem rather ineffective taking into consideration the petty protection of the property rights in the country.

Another interesting detail is the expenditures for economic activities and services, third in size, in the budget as a percentage of GDP. Here are included the different programs, subsidies for certain areas such as the agriculture, energy sector, transport, and other industries, as well as

the expenditures for infrastructure. They represent 4.5% of GDP in 2006 and are at a relatively fixed rate. Practically this means that the country still tangibly participates in spheres of the economy which are not typical of it, instead of giving the chance to the private sector to undertake the costs, investments, and the management of these activities. In this respect that creates grounds for corruption, ineffective expenditures and incapability to reduce the tax burden due to the indispensable financing of these expenditures.

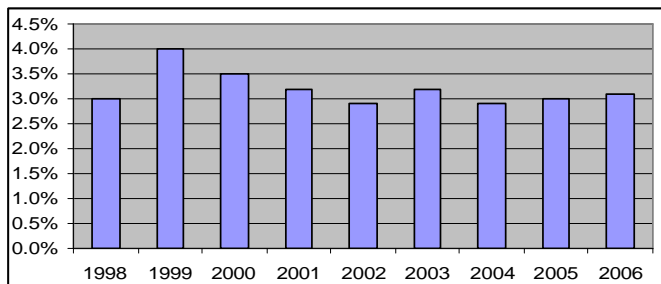
Increase in the expenditures for the period 2004-2006 is observed in the area of general state services, which means that the present government actually spends more money on administration and different public utilities. On the one hand, this is a result of the increase in the number of state administration, and, on the other hand, it is a result of the income policy which uses as an instrument the salaries in the budget sector in order to influence the salaries in the private sector.

### *Instead of a conclusion*

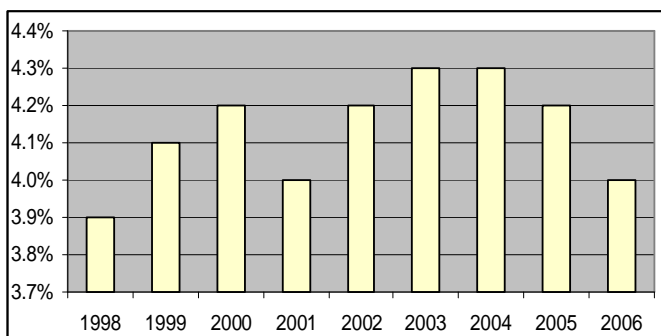
The most general conclusions would be the following:

- There is a reduction of the expenditures in certain areas of the economy, but that has not stimulated the government to significantly reduce the highest taxes - taxes over labor. That is why the social expenditures in the budget are also the highest and do not significantly decrease during the years.
- It is apparent that there are solid resources for reducing the tax burden through an increase in the effectiveness of the expenditures and a decrease in the budget surplus.
- The high government spending is not tantamount to a just society. The substantial expenditures mean high taxes, highly distributive role of the government, and restriction of the individual freedom of citizens. In many of the countries with significant government spending the low-productive majority lives on the back of the highly-productive minority, which finances the government expenditures.

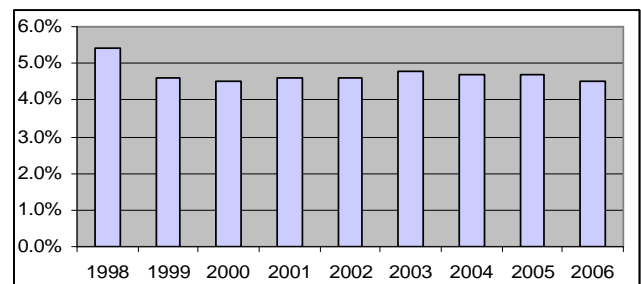
Budget expenditures for general state services (% of GDP)



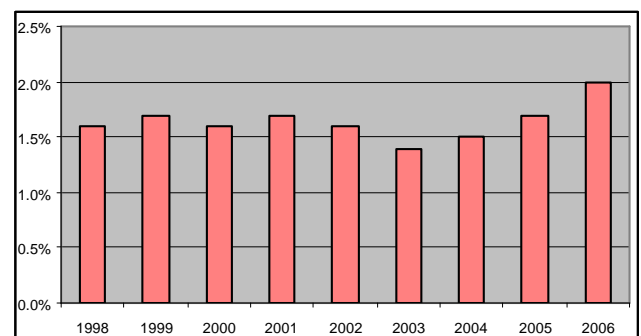
Expenditures for education (% of GDP)



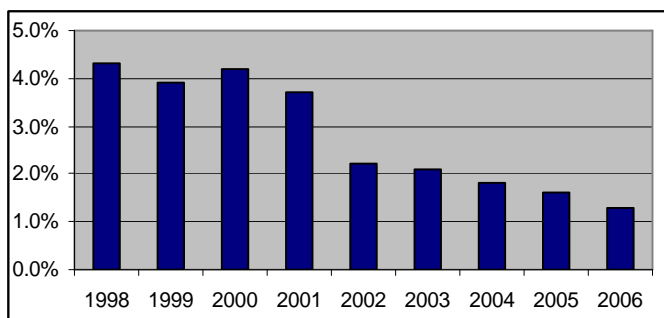
Budget expenditures for economic activities and services (% of GDP)



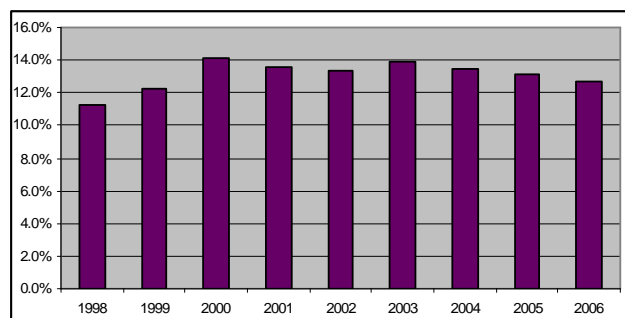
Expenditures for housing organization and public utilities (% of GDP)



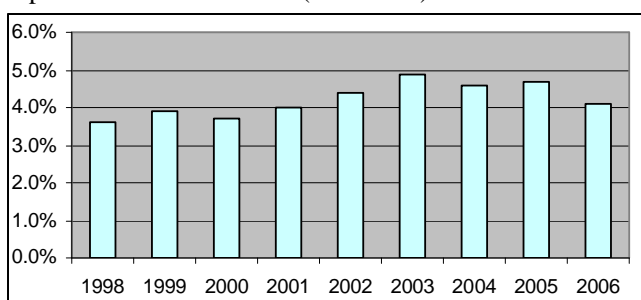
Expenditures not classified by the other functions (% of GDP)



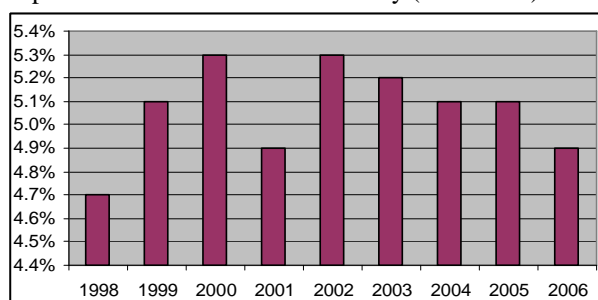
Expenditures for social security, social assistance, and welfare (% of GDP)



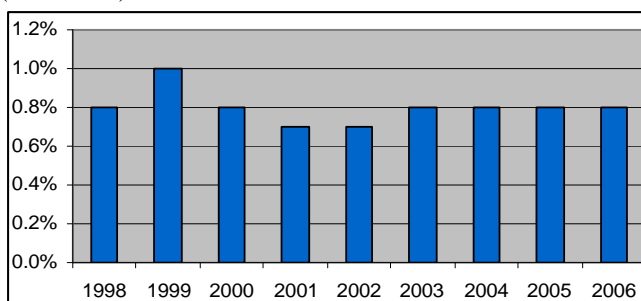
Expenditures for healthcare (% of GDP)



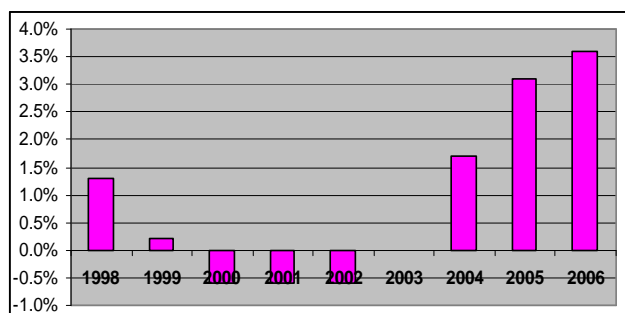
Expenditures for defense and security (% of GDP)



Expenditures for recreation, culture, and religious activities (% of GDP)



Surplus (% of GDP)



### The State Budget by March 2007

Dimitar Chobanov

The Ministry of Finance has recently announced the data on the implementation of the state budget toward the end of March 2007. The total revenues in the consolidated budget reach 5.051 billion leva, and the total expenditures- 4.334

billion leva. Consequently, the surplus is 539.5 million leva, which is equivalent to around 1% of the expected GDP for this year.

The growth of total revenues is more than the growth of expenditures for the first three-month period of the year. While the revenues in the consolidated budget increase with 15.4% compared to the same period in 2006, the expenditures increase more slowly - with 9.8%. The tax revenues rise with 12.2% which is

mainly due to the revenues from corporate tax and excise duties. While in the case of excise duties the high contributions to the total revenues are due to the rise in the rates, in the case of profit tax the rate has been reduced to 10% in the beginning of the year. Although it is early to make any explicit conclusions and the revenues up to this moment are defined almost completely by the former rate, the increase of 45% indicates that this measure reduces the incentives for evasion and “brings to light” a part of the profits in the economy. Business possesses more affinity to pay, as the costs of hiding are close to, or even exceed, the costs of paying.

A stable increase in terms of the revenues from the personal income tax is also observed - an increase of 22.2% compared to the same period of the preceding year, while the revenues from social security contributions rise with 10.8%, despite the redistribution of 1% point to the fully funded pillar. A part of the explanation for this increase lays down in the expansion of the base due to higher incomes and employment. Still, the extension of the range of personal income tax, which already applies to foreign persons and also affects the social expenditures, should also be taken into consideration.

The development of the VAT revenues is according to the expectations. While during the first two months of 2007 a substantial decrease in this indicator was registered - for example, in January the decrease was with 30.7%, now the decrease is with around 7.2%. The reason is that the EU membership resulted in changed regime of taxation. Yet till the end of the year a growth in the VAT revenues is expected, as in this case they will probably exceed the revenues, already collected in 2006.

The growth of the expenditures in March compared to the same period of the preceding year is with 9.8% which represents an acceleration of the rate compared to the first two months of this year. The growth in January 2007 was moderate-2.6%, and in February-7.9%. In comparison with 2006, during the whole year the rate is 9.7%, while the increase in the nominal GDP is with 14.7%. This development allowed for the reduction to the lowest value of the percentage of state expenditures for manufactured goods in the last years. Maintaining this policy by the government (the policy of slower increase in the state

expenditures in relation to GDP) will also allow for a decrease in the redistribution through the budget. This means that it is possible to follow a conservative fiscal policy by means of sustaining a surplus, and in addition certain resources will be made available for a reduction of the tax burden.

The recent proposals by one of the parties from the ruling coalition do not unfortunately correspond with such a policy. The proposed ideas are mostly directed to a solid increase in the government expenditures, however without being accompanied by any intentions for their optimization. Still, in the framework of the coalition, and mostly from the standpoint of the Ministry of Finance, these proposals might not be even approved and implemented.

The execution of the budget during the first three months of the year is a result of the positive development of the economy. The hypothesis that people act rationally in principle and react to the fiscal stimuli is confirmed. The reduction of some tax rates is effective and leads to higher incomes and employment, and to a more adequate account of these indicators in the government statistics. The percentage of the “gray economy” is still high, which could be changed through a further reduction of taxes. This reduction can occur through optimization and, accordingly, through restriction of the growth of state expenditures. The way to do this is to extend the reforms in the pension system, healthcare, education, public administration, and management of state property. It is the sustenance of a long-term stability and improvement of the effectiveness of these expenditures that should be the major goal of every government.

## A Perspective over the EU Funds

Adriana Mladenova

The threat of not being able to master the money from the EU Structural and Cohesion Funds and from the agricultural subsidies is one of the widespread and extensively discussed topics in the public space. Although our country joined the EU on 1 January 2007, the programs of the EU Funds, as well as the application process, have not started functioning yet. But in the first two months the state made its mandatory contribution to the EU budget to the amount of 146,6 million leva. According to the treaty obligations with the EU, Bulgaria should contribute to the budget of the Union 1,2% of its annual GDP, as the amount for 2007 is expected to exceed 640 million leva. In exchange for these payments the state receives a share of the EU budget in the form of subsidies and gratuitous relief funds. The subsidies and relief funds amount to the large sum of 4,6 billion leva for 2007-2009 period, which is allocated in the following spheres:

- 1) Agriculture- 1,5 billion euro
- 2) Policies of restructuring (building of infrastructure, competition between firms, and regional development)- 2,3 billion euro
- 3) Domestic policies, improvement of the administration, and budget compensations- 730 million euro

### Assimilation of the EU Funds from the new member-states

The Ministry of Finance has published data on the financial implementation of the pre-accession programs in Bulgaria toward the end of March 2007. The data might be an original indication for the future assimilation of the instruments of the structural funds and financial resources, provided for the implementation of CAP (Common Agricultural Policy), although these funds, only for 3 years, represent more than two times the budget of the pre-accession programs.

The data shows that the implementation of SAPARD program (which finances the agriculture and food, wine, and tobacco industries) is 95%, while the implementation of

FAR program is 64% and of ISPA program (which finances infrastructural projects on the national level) is 43%. As ISPA has the biggest share in the aggregate amount of the resources provided from the pre-accession programs, the assimilation in the beginning of 2007 represents on the average around 60% of the total amount of the funds. The situation in Romania is similar. The implementation of SAPARD program is over 95%, and of ISPA program is around 35%. This indicates that in these two countries there is a lack of willingness for managing big infrastructural projects, as this reluctance is often prompted by political reasons or insufficient financial and management capacity of the local authorities to implement infrastructural projects.

The leader in the assimilation of the EU funds from 8 of the newly-accepted EU member-states is Slovenia, which in October 2006 agreed upon 43% of the budget, provided for subsidies and relief funds for the period. The second place is taken by Estonia with 39%, followed by Hungary-31% of the resources provided by the agreement. The last places of the "assimilation contest" are taken by the Czech Republic, Slovakia, and Poland which have agreed upon around 15% of the common budget of the EU funds, provided by the financial agreements of these countries with the EU. It is evident that in all the above-mentioned member-states the assimilation process of the funds in the beginning of their membership is relatively low.

As a whole, the net effect from the EU membership over the budget is negative, due to the duty of co-financing the projects of the EU funds from the state budgets, the advanced financing of the approved projects, the countries' contributions to the EU, and the costs of sustaining a larger administration as a result of administering the subsidies and transfers.

### Some of the widespread myths about the EU funds are the following:

- 1) **The EU Funds must be 100% assimilated.**

Bulgaria is the country for which the biggest amount of subsidies and relief funds from the Structural and Cohesion Funds as a percent of GDP has been agreed upon. The fear that the country would not be able to take a full advantage of this "privilege" and to assimilate all money is one of the leading criticisms against both the politicians and the business circles in

the country. However, in reality the assimilation of funds depends not only on the administrative capacity, but also on the macroeconomic capacity of the country to undertake specific projects in exchange for the provided money. The distribution of funds in different sectors depends on the re-assigned, centrally prepared tasks and priorities. The real needs of the economy may be differentiated from the guaranteed spheres of financing. The desire to assimilate all resources at any cost in this case will lead to big distortions in the economy, changes in the relative prices of goods and services, pro-inflation pressures, and to implementation of projects which later on appear to be unprofitable.

The interventions distort the behavior of the entrepreneurs. Instead of striving for increasing their output, some firms will make more profits if they design projects with which to apply for EU funding. However, the logic of the market is exactly the opposite- an entrepreneur conceives a business idea and then he looks for ways to finance it. The market functions on the principle of natural selection and these projects, which possess the biggest potential to become profitable, are financed. The investment of own resources is an incentive for entrepreneurs and investors in order to correctly evaluate projects and to aim at making a minimal number of mistakes in their evaluations. This is not applicable to officials who operate with somebody else's, not their own, money.

**2) The control in the EU over the spending of the resources from the EU Funds is more reliable and the misappropriations are less.**

The mechanism of distributing the subsidies and relief funds is related to large transaction costs over the construction of clumsy administrative structures. The aggregate amount of resources from the EU funds, which should be distributed among the 27 EU member-states in 2007, adds up to approximately 100 billion euro. Everywhere in the world the concentration of excessive power and discretion in the hands of public organs creates pre-conditions for the formation of corruption, rent-seeking, and lobbying for the interests of certain groups. Scandals and disclosures of abuses of EU funds are an inseparable part of the EU existence and

are not characteristic only of Bulgaria and Romania, or the Eastern European countries as a whole, but also of countries of "Old Europe" like Greece and Italy. It is indicative that already 12 years in a row the European Chamber of Accounts does not certify the EU budget due to omissions and suspicions of abuses, and of "mistakes in the legality and regularity" of reporting the common funds.

**3) The poor regions may achieve more substantial economic growth through receiving money, without making any effort.**

The prosperity and long-term economic growth may only be a result of the rise in the labor productivity and the increase of investment and capital in the economy, but not a result of the artificial increase of money aggregation in the economy. Some studies have appeared that prove that the attraction of technological innovations in regions with untrained labor force, insufficient resources, and inappropriate conditions for the development of high-technological business may lead to more costs for people than potential benefits.

On the other hand, subsidies create a culture of dependence and do not stimulate the innovations and the enterprising spirit of the market players. For example, subsidies are the reason for making short-sighted decisions and sustaining unprofitable and losing productions. The Community policy in the sphere of banana production stimulates the European producers in France and Spain to raise the output, although their costs are times higher than the costs of Latin American producers. In the long run, without relying on the EU officials for their support, the producers will go bankrupt.

The conclusion is that the EU funds will not solve the country's inherent problems related to low incomes and unsatisfactory quality of services in some public spheres like the education and healthcare spheres. In order to improve the well-being of people, real economic reforms and maintaining of favorable institutional and political environment are necessary tools.

## The Legislature in Bulgaria: What happens There?

Veliko Dimitrov

In order to get a more precise notion about the “evolution” of the legislative assembly and the law-making process in Bulgaria, we could examine the Parliament in two aspects, namely, in the micro and macro aspects. Each of these aspects possesses its own characteristic features and probably dynamics (although it is not clear in which direction each kind of dynamics develops). On the first level is the way of life of every member of Parliament, and on the second level is the combination of all 240 deputies, respectively the law-making process and, on a larger scale, the economic development of the country (this last allusion does not howsoever come into question, taking into consideration the availability of a great number of similar writings- some economic in nature, with or without meaning; others sociological, written by politicians, including ministers,<sup>1</sup> as all those mentioned categories are of course complementary to each other).

The micro-level of the legislation has a few unique attributes. Some individuals, “units” in the legislative process among which are specific political leaders, are regularly absent from the Parliamentary sessions (which literally means absent from the official positions and duties bestowed on them by the people). Other “units” in the legislation, colleagues of the aforementioned politicians, like to play the role of “substitutes” for them, even for several politicians at the same time, despite the fact that at the time of general elections, as well as at the time of voting in the Parliament, every deputy still has only his/her own vote at his/her disposal. And polygamy is against the law!

<sup>1</sup> Strangely, but it appears that the Minister for State Administration has written with his own hand a short macroeconomic review with adjoining evaluations, which probably, despite the positive intentions of the author to clarify a bit basic economic issues to his boss, should not be read by beginners in economics. The review can be found [here](#). Still, it is worth noting that minister Vasilev by himself, in contrast to almost all of his colleagues, can write or tell something which is not a pure populism, nonsense, or just a bad sense of humor.

Other landmarks from the Parliamentary landscape are also the regular interviews willingly given by the national law-makers, something which does not represent a negative aspect by itself. But the manner in which the interviews are given is definitely negative. The interviews are not about views and convictions, but mostly about political parties, officials and their faults, and respectively about foreseeable and logical results. Moreover, the interviews appear to be about people, while in reality the emphasis is only on specific groups of the society; often the interviews comprise the term “public,” while in reality they are all about the “state” (for example, state orders which, as it is well-known, represent the basic mechanism through which the state buys goods and services). The interviews are also about politics, government and leadership, but they are actually about the formation of conditions (whatever they could be) as well as about harmonization, when *de facto*, with some exceptions, only a particular set of rules, between which one should choose, should be taken into consideration.

What is happening on the macro-level of the legislation? A few very important things for sure:

1. According to the Statute for the Organization and Functions of the National Assembly,<sup>2</sup> the bills must be introduced along with binding motives, which must also include an evaluation of the expected consequences including the financial aftermath.

It is an open secret that such an evaluation is not usually made, although, except in the Statute, such a requirement is also written down in the Law for Restricting the Administrative Regulation and Control over the Economic Activities. Indeed this law has to do solely with introduction of regulatory regimes (a part of the regulations) which duly means that in specific cases the inaction infringes one act, while in other cases- two or more acts.

2. In order to present public motives (it is clear that there is no evaluation), it follows that there should be a text of a bill to which to apply these motives. At the time of their introduction, all bills should be immediately registered in the Public Register for “Bills” and they

<sup>2</sup> You can read [here](#).



should be accessible on the webpage of the National Assembly.

In part of the cases this requirement is observed, but experience shows that there is a number of bills whose contents are completely missing, which is inadmissible.

Let me give you a few examples:\* the current 11 bills are examined as the ratifications are excluded. In the following 6 bills all kind of content is completely missing.

- A Bill for Amendment to the Code of Social Security (look [here](#))
- A Bill for Amendment to the Law of Corporate Income Taxation (look [here](#))
- A Bill for Amendment to the Law of State Orders (look [here](#))
- A Bill for Amendment to the Law of Income Taxes over Physical Persons (look [here](#))
- A Bill for Amendment to the Law of the Political Parties (look [here](#))
- A Bill for Amendment to the Law of Elections of Members from the Republic of Bulgaria for the European Parliament (look [here](#))

3. It is not clear in what order the bills enter the Parliament. There are no explicitly written rules which can determine certain logic and order in the examination of the introduced bills (for instance, by date of introduction or by allocation to a leading commission). In that way a part of the proposals are delayed with months and years, while other proposals (introduced by the Council of Ministers, i.e. by the ruling majority) are discussed and accepted with priority. From the first 35 proposals in the present Parliament, there is not even one bill

introduced by the Council of Ministers which is under a regime of discussion, while there are some bills under discussion introduced by particular deputies (some of these bills were introduced more than a year and a half ago).

4. To what extent do the law makers possess the initiative to accept standards, regardless of the executive?

In Bulgaria the Council of Ministers, as well as all members of Parliament have the right of initiating legislative acts. From all 664 bills introduced in the Parliament till the present moment almost half of them (331) are initiations by the Council of Ministers. The rest (333) are introduced by one or more members of Parliament, including those elected members belonging to one of the three political parties forming the ruling coalition. It could be accepted that more than half of the proposals are directly or indirectly introduced by the government, or in other words, by the executive, not by the legislature.

Having this in mind, it has often happened to me to level criticisms against the members of Parliament with respect to certain proposals. Probably the right thing to do is to direct a share of my criticisms towards the government as the actual carrier of around 50 and more percent of the state power (it is not 1/3 of the state power as recognized in the books representing the idea about the perfect division of power between the legislature, the executive, and the judiciary).

\* The complete database of the register for "Bills" can be accessed on this webpage:

<http://www.parliament.bg/?page=app&lng=bg&aid=4&action=execute>

## A Supreme Absurdity

Peter Ganev

In 1999 the Bologna Declaration for the creation of a European Higher Education Area was signed. This document, as a turning point in the development of higher education in Europe, was

signed by 29 countries including Bulgaria. The Bologna Declaration clearly outlines the ever-growing need for greater independence and autonomy of universities as a major factor in the development of Europe.

## A failed reform

Just a few hours ago the Bulgarian government manifested that it could in no way adopt these



values. According to the results from the second reading in the Parliament about changes in the Higher Education Law, universities will not be able to determine on their own the tuition fees and the number of enrolled students (which means that there are no changes here), but instead at every state university a Board of Trustees will be created which will include people, outside the university body.

The establishment of these boards has been widely discussed in the social circles in the preceding month but nobody, in general, could explain for what exactly these boards are necessary (they are created by law, not by an initiative of the higher educational institution itself) and how come these boards of trustees correspond with the idea about independence and autonomy of universities? In your opinion, what can a Board of Trustees do, except “insisting” that various things should be done?

Although the interference of such a board of trustees in the administration of universities clashes with the idea of autonomy of the academic community, it was not this change that drew the attention. The entire discussion about reforming the system of higher education was initiated by the Minister for Education himself, Daniel Vulchev, who also promoted the idea to give universities the right to determine their own tuition fees and number of enrolled students. In fact, that was the excuse for the creation of a Board of Trustees. Let the higher educational institutions have more freedom in order to be able to compete effectively but, anyway, in order not to make a mess in the field let's create a Board of Trustees that should supervise and restrict “(excessive) freedom.” At first sight it seemed that the above-mentioned line of thought was in balance with all standpoints and interests. However, things appeared to be completely different.

### **Again about tuition fees**

Where has this fear of increased tuition fees come from? If there was something that intercepted the desire for changes in the higher education (if there has been such a desire at all!), that undoubtedly was the perception for potential rise of tuition fees. Medical students would almost have to pay around 4000 leva (2 045 euro) because that amount of money represented

the allowance for a student of medicine. The allowance may be 4000 leva but as if everybody forgets that the right of universities to determine higher tuition fees does not mean an immediate reduction of state subsidies for students. Universities will again be financially provided for, even if they do not raise the fees. Even the first-year students in economics know about the so called equilibrium of demand and supply and nobody can afford to determine unrealistically high prices for no matter what products or services. There will definitely be universities which will increase their tuition fees but that will be as a direct result of the quality of education.

### **Student credit financing**

One of the widespread opinions at the time of the discussions of the law and, more specifically, of the tuition fees was that the changes should be made in a moment when an active system for student credits is constructed. It is not a secret that anything like students' crediting does not exist in Bulgaria. Despite the substantial number of credits under this name, these are always connected with proof of sufficient income by the student if he/she by accident works, or by a parent who in practice repays the loan. There are a few reasons why this kind of credit, when a loan is issued to the student (the loan can be repaid by the student when he/she starts working after graduation) only on the basis of recommendations and results from the relevant university, has not still taken place in Bulgaria.

One of the reasons is directly related with the market and with the fact that our financial system is still under development, and these high-risk credits are yet to begin entering the market.

The second reason, probably the more serious one, is absolutely unrelated to the market, but is determined by the perpetual intention of the state to enter into the “credit” undertaking. Which ordinary creditor is about to invest and profit from student credits is the state, sooner or later, will start giving such credits under much simpler (not market) conditions, as the credits might not even be repaid? This anti-market behavior, which not only will not yield profits, but also will be financed through the budget, is the absolute barrier for everybody who would like to enter the market.

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